CA2ALTD
79R23
c. Prepl.

LEGISLATURE LIBRARY
NOV 1982
EDMONTON

A RE-ASSESSMENT OF THE ELEMENTS
OF AN ECONOMIC STRATEGY
FOR THE PROVINCE OF ALBERTA

# VOLUME II

## THE GLOBAL ECONOMIC AND POLITICAL ENVIRONMENT AND ITS IMPACT ON ALBERTA

Prepl.

PREPARED FOR
THE GOVERNMENT OF THE PROVINCE OF ALBERTA
BY
SRI INTERNATIONAL

SEPTEMBER 1980

SRI International

CLIENT PRIVATE

# A RE-ASSESSMENT OF THE ELEMENTS OF AN ECONOMIC STRATEGY FOR THE PROVINCE OF ALBERTA

## VOLUME II—THE GLOBAL ECONOMIC AND POLITICAL ENVIRONMENT AND ITS IMPACT ON ALBERTA: 1980-1995

SEPTEMBER 1980

Prepared For:

The Government of the Province of Alberta

Prepared By:

Donald C. Baron
Kenneth H. Jacobson
Robert W. Davenport

SRI International

333 Ravenswood Ave. • Menlo Park, California 94025
(415) 326-6200 • Cable: SRI INTL MPK • TWX: 910-373-1246

# VOLUME II

## CONTENTS

90-03541/

CONTENTS


LIST OF ILLUSTRATIONS . . . . . v

LIST OF TABLES. . . . . v

I INTRODUCTION . . . . . 1

II SUMMARY. . . . . 5

Global Environment . . . . . 5
Implications for Canada. . . . . 9
Canadian Economic and Political Outlook. . . . . 11

III WORLD POLITICAL OUTLOOK. . . . . 15

Introduction . . . . . 15
East-West Relations. . . . . 15
The Volatility of the Middle East. . . . . 20
Developments in the Pacific. . . . . 22
North-South Relations. . . . . 24
Transnational Problems . . . . . 25
The North American Triangle. . . . . 26

IV WORLD ECONOMIC OUTLOOK . . . . . 29

Introduction . . . . . 29
Overview of the Economic Outlook . . . . . 30
Sources of Economic Growth . . . . . 31
Resource Constraints . . . . . 34
Other Constraints on Growth. . . . . 39
Economic Outlook for Major Countries and Regions . . . . . 46
Implications of the World Economic Outlook for Canada. . . 50

V CANADIAN ECONOMIC AND POLITICAL OUTLOOK. . . . . 55

Overview of the Economic Outlook . . . . . 55
Economic Links Between Canada and the United States. . . . 57
Population . . . . . 59
Energy . . . . . 59
Capital Investment . . . . . 60
Productivity and International Competitiveness . . . . . 61
Balance of Payments. . . . . 63
The Political Framework for Business Activity. . . . . 67
Implications of the Canadian Outlook for Alberta . . . . . 70

VI ALTERNATIVE SCENARIOS. . . . . 73

Base Case. . . . . 73
Alternative 1: Weak World Economy . . . . . 75

VI ALTERNATIVE SCENARIOS (Continued)

Alternative 2: Higher Oil prices. . . . . 76
Alternative 3: Lower Oil Prices . . . . . 76
Alternative 4: Weak Canadian Dollar . . . . . 77

## ILLUSTRATIONS


| | | Page |
|---|---|---|
| 1 | Global Forces That Affect Alberta and Canada . . . . . | 3 |


## TABLES


| | | |
|---|---|---|
| 1 | Average Annual Growth of Real Gross National Product . . . . | 31 |
| 2 | Canadian Economic Indicators . . . . . | 55 |
| 3 | Canadian Balance of Payments, 1970-1979. . . . . | 64 |
| 4 | Major Economic Parameters of Alternative Scenarios . . . . . | 74 |

# VOLUME II

## CHAPTER I

## INTRODUCTION

# I INTRODUCTION

It is apparent that Alberta's economy is dependent to a significant extent on developments outside the boundaries of the Province. For example, the prices of some of its major commodities--oil, gas, and agricultural products--are largely determined by international market conditions. As well, prices of such potentially major exports as petrochemicals and forest products are influenced by international forces. The demand for other goods produced in Alberta is often affected by the economic climate in the rest of Canada, the United States, and other parts of the world. Alberta also is subject to many of the political and social forces that have become increasingly important both in Canada and within the larger global community.

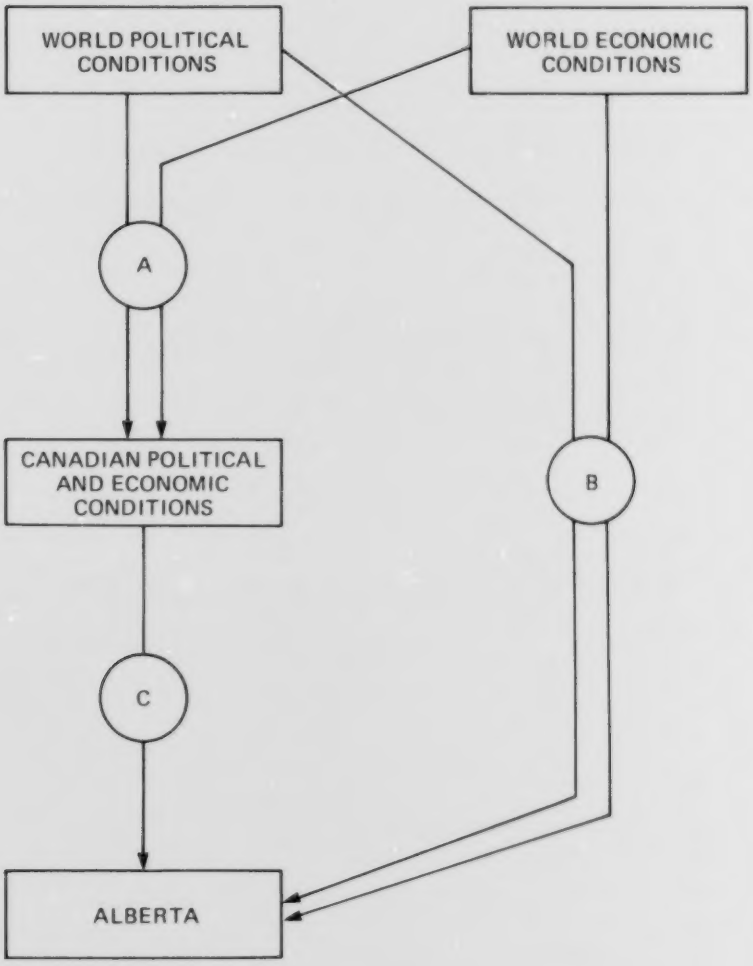
This interdependence with the rest of the world will become even greater in the future. Energy, and perhaps agriculture, will be more important to the world economy in the 1980s than in the 1970s. In addition, as Alberta moves to diversify its economy and as its role as a regional financial center expands, its linkages with the rest of Canada and other countries will strengthen. Alberta's growing importance within Canada also ensures an ever greater role in Canadian and international political and economic affairs.

With this perspective, the objective of Volume II of this report is to describe the major aspects of the global political and economic environment that are expected to occur during the 1980s, with particular focus on those that will impact most significantly on Alberta. The

general approach to this task consisted of three steps. First, the continuing and emerging forces that are expected to shape economic and political events in the next 15 years were identified. Second, these forces were then evaluated and integrated to produce a consistent world overview. Finally, several elements of the world view that appeared to be both highly uncertain and of particular importance to the future of Alberta were selected, and alternative assumptions concerning their outcomes were made so as to explore the range of uncertainty in the external environment to which Alberta will be exposed.

Figure 1 illustrates the selection process that was used to identify those elements of the global environment that are of particular significance to Canada and Alberta. World political and economic forces impact on Canada (as represented by A in the figure) because Canada: is an industrialized democracy closely aligned with other western countries through a shared economic system, international financial and trade ties, and military alliances; is integrated with the world economy and thus is subject to forces beyond those operating among the developed countries; is closely tied to the United States culturally, financially, and economically; and is a major producer of several commodities of global importance, particularly oil, gas, and agricultural products. World political and economic conditions also impact directly on Alberta (represented by B in Figure 1) primarily through its role as a producer of energy and grain. Finally, Alberta is also influenced by Canadian political and economic conditions (indicated by C in the figure)--not only the general economic and political environment, but also specific issues such as taxation, export policies, transportation policies, and the separation of powers between the federal and provincial governments.

## GLOBAL FORCES THAT AFFECT ALBERTA AND CANADA




SOURCE: SRI INTERNATIONAL

FIGURE 1

Section II of this report presents a summary of the principal characteristics of the global outlook in the 1980s and some of the major implications of this outlook for Alberta. The third section discusses the political elements of the world outlook, and Section IV examines the economic outlook. The fifth section focuses on developments within Canada, both political and economic. The final section identifies major uncertainties in the global environment and describes four alternative scenarios designed to reflect a range of feasible conditions.

# VOLUME II
## CHAPTER II

### SUMMARY

## II SUMMARY

### Global Environment

#### World Political Outlook

1. The 1980s promise to be the most perilous decade since the peak of the Cold War. The early 1980s will be particularly dangerous because of the ongoing buildup of Soviet military capabilities and the political and social tensions in the Middle East.

2. International politics will continue to be dominated by the relationship between the United States and the USSR. There will be no substantial amelioration of tensions between the two superpowers.

- U.S.-Soviet relations have been deteriorating since the 1972 Moscow summit at which the first SALT accords were signed. Since then neither the American hopes for a restrained Soviet military posture nor the Russian hopes for improved access to U.S. technology and favorable loan treatment have been realized.
- The balance of strategic and conventional military power has shifted in favor of the USSR. The momentum of current programs will increase the Soviet advantage throughout the early 1980s. U.S. efforts to counter this shift in power will not have appreciable effect until the mid-1980s at best. However, a consensus appears to be building in the West that the Soviet challenge must be met, and most of the European members of NATO have joined the United States in pledging to strengthen their military capabilities.

3. The Middle East will remain volatile. Continuing sources of tension will be: Soviet adventurism, the Arab-Israeli conflict, the internal fragility of many regimes, traditional-radical splits within the Arab world, regional rivalries, massive transfers of sophisticated armaments, terrorist activity, and the regional potential for nuclear weapon proliferation. Thus, as western oil dependence grows, Soviet

influence continues to increase in the region, and internal political stability in some countries deteriorates, interruptions in oil supplies must be anticipated.

4. Potential for armed conflict is considerable elsewhere--the Indian subcontinent, Africa, and Latin America. In some cases, clashes between client states of the superpowers may occur, but escalation to a major conflict between the superpowers is unlikely. Soviet support for "national liberation" movements in the Third World, however, will be a continuing concern, particularly in Southwest Asia, Africa South-of-the-Sahara, Central America, and the Caribbean.

5. The outlook for political and military stability in East Asia in the next 15 years is rather favorable. Growing cooperation among Washington, Tokyo, and Beijing in an effort to contain the Soviet-Vietnamese alignment is expected. Both Japan and China are likely to modernize their conventional military forces with U.S. approval and support. Sufficient strategic and political stability to permit continued economic development, especially among the Association of Southeast Asian Nations (ASEAN), is probable.

6. Calls for a new international economic order will continue to serve as a rallying point for Third World countries, but the cohesion of these countries is fragile due to their disparate political, economic, and social characteristics. The newly industrializing countries and other rapidly developing or comparatively well-endowed Third World countries will increasingly view their interests as requiring closer ties to the developed countries.

World Economic Outlook

1. World economic growth in the 1980-1995 years will be moderate at best in most countries. The growth rate of real world gross national product (GNP) will be well below the level achieved during the rapid growth period of 1950 to 1973.

- Real economic growth in the United States in 1980-1995 will average about 3.0% per year, somewhat below the 3.4% per year long-term post-war average.
- The Japanese economy will grow at a 4.7% rate in real terms in 1980-1995. The abrupt transition from 10% annual growth in the 1950s and 1960s to growth rates half that level in recent years has forced a shift to a greater emphasis on generating internal demand rather than export-led growth.
- Average real economic growth in Western Europe will be about 3.0% per year in 1980-1985, compared with 5.0% in the 1950-1973 period. The perception of economic malaise that has pervaded Europe since 1974 will continue in the 1980s.
- The most rapidly growing economies will be those of the newly industrializing countries--Korea, Taiwan, Hong Kong, Singapore, Mexico, Brazil, Portugal, Spain, Greece, and a few others. Their growth strategies will emphasize the export of basic manufactured goods such as textiles, footwear, steel, and electrical products.
- Most of the lower income developing countries will face very serious economic difficulties, compounded by weak export markets and high oil import costs.

2. The fundamental sources of long-term economic growth--increases in the labor supply, capital investment, improved technology, better management, and economies of scale--will still be operative in the future. These forces, however, will be hampered substantially by a number of basic problems that will cause considerable difficulties for almost every country at various times in the next 15 years.

- Inflation will remain an almost constant concern in most developed countries. Only Germany and Switzerland are likely to have average inflation rates of less than 5% per year in the next decade and a half. Canada and the United States will struggle to bring inflation down to the 6%-7% range, while the United Kingdom, France, and Italy will have difficulty keeping their inflation rates below 10%.

- Unemployment will likewise remain a major concern. The problem will be particularly severe in Western Europe where unemployment rates will be several times as great as in the 1950s and 1960s (although slightly lower than current levels).
- Balance of payments problems will occasionally affect individual developed countries, but will not be a decade-long problem of the magnitude of inflation and unemployment. Some developing countries, however, will face almost permanent balance of payments crises.
- Governments will become even more active in economic management than before although this will take the form of government ownership of enterprise less frequently than in the past. Governments will increasingly offer tax incentives and employment subsidies to private business.
- The international monetary system will continue to be a shifting amalgam of managed exchange rates and moderate constraints on international capital flows. Large financial surpluses built up by the OPEC countries as a result of high oil prices will be a destabilizing force in international markets, but no breakdown in the system is anticipated.

3. Energy will continue to be a major preoccupation for every country in the world.

- The crux of the energy problem is uncertainty over the cost and security of supply of oil. Political instability in the Middle East and the potential for further chaos in Iran and several other OPEC countries create a significant chance of periodic supply interruptions and price jumps.
- The average annual rate of increase of oil prices in the 1980-1995 period is expected to be about 2% greater than the world inflation rate. But oil price changes are not likely to be uniform year-to-year; they will probably follow the pattern of the past 5 years--infrequent large increases followed by periods of moderate change. This pattern will continue to create a semi-crisis atmosphere in the oil importing countries and will be an important factor in international relations.

4. The availability and cost of nonenergy raw materials will not be a major problem. Adequate supplies of most minerals exist and are available from a variety of sources. Effective cartels with substantial control over prices are unlikely. Prices on world markets will continue to fluctuate considerably, but on average will not increase much faster than prices in general over the next 15 years. A few relatively minor

minerals, such as chromium and cobalt, that are produced primarily in politically unstable areas may be subject to supply interruptions or sustained price surges.

5. World food supplies are generally expected to be adequate to feed a growing world population. However, a number of very poor countries will not be self-sufficient in food production and will require international assistance. Improving diets in the higher income developing countries may lead to greater import demand for some agricultural products, including wheat.

Implications for Canada

1. Because future economic growth in Western Europe and Japan will be much less vigorous than during most of the postwar period, European and Japanese businessmen and investors will increasingly look outside their countries for investment opportunities. The developing countries will be major recipients of capital flows from Europe and Japan, but several industrialized countries--including Canada, the United States, and Australia--will also be attractive. The Europeans and Japanese may be particularly interested in investments in resource-related areas.

2. Modest growth prospects in the industrialized countries, plus a gradual shift of basic manufacturing to the developing countries has led many countries to pursue high-technology industries as a source of future growth. Thus, competition will be fierce among countries and regions to attract companies already active in these industries and to support high-technology research and development.

3. The combination of modest economic growth and intractable problems, such as energy costs and availability, inflation, unemployment,

balance of payment deficits, and intense export competition, will increasingly politicize international economic relations.

- Trade protectionism will probably become more prevalent. Following the pattern of recent years, this will consist largely of temporary import quotas and voluntary export restraints. The overall impact of such measures will be relatively minor, but disruptions of trade in some products could be a significant problem for some countries. Despite the movement toward more controlled trade relations, however, a reversal of the postwar trend toward lower tariff levels worldwide is unlikely.
- The overall global balance between the supply of and demand for food is expected to be adequate, but a number of very poor developing countries will be unable to meet their own food needs and to afford to import sufficient food supplies. Food exports may become an increasingly visible issue in the international arena and pressures may grow for greater volumes of concessionary food shipments by the major exporters of agricultural commodities.

4. Because of its favorable political and economic outlook, East Asia will be increasingly important to Alberta and the rest of Canada. Export opportunities for raw materials to resource-poor countries such as Japan, South Korea, Hong Kong, Taiwan, and Singapore will expand. The demand for Canadian agricultural exports will also increase as living standards improve in the region. Canada may also benefit as a gateway to the North American market for East Asian exports.

5. Political and economic links between Canada and the United States will remain close. However, the growing importance of Mexico to the United States will alter the nature of Canada-U.S. relations.

- The United States will purchase increasing amounts of oil and gas from Mexico to reduce its dependence on energy imports from less reliable countries and will seek cooperation from Mexico in countering Marxist insurgency movements in Latin America. Mexico will seek greater access for its agricultural and industrial exports to the United States and will push for a more liberal U.S. immigration policy to relieve some of its population and unemployment pressures.
- Mexico's increasing importance to the United States will complicate the special U.S.-Canadian relationship. The United States

will be forced to display an even-handed policy toward its neighbors to the north and south.

Canadian Economic and Political Outlook

1. The Canadian economy will experience moderate growth in the 1980-1995 period. Real GNP is expected to grow at an average rate of about 3.5% per year, somewhat more rapid than during the past 5 years, but considerably slower than the robust growth experienced in the 1950s, 1960s, and early 1970s.

2. Inflation and unemployment are likely to remain major concerns throughout the period. Unemployment, which averaged 5.0% per year in the 1960-1973 period and 6.6% per year in 1974-1978, is expected to average almost 7.0% annually during the next 15 years. Inflation will slowly recede from current levels, but will still average about 7.0% per year in 1980-1995.

3. The balance of payments will also be a significant constraint on the economy well into the 1980s.

- The merchandise trade surpluses of the past may be even more favorable in the future in response to both stronger world demand for resources and to the weakening of the Canadian dollar that has occurred during the past 2 years. However, the deficit on services, which in 1978 was twice as large as the surplus on trade, may worsen.
- Debt service has become a large and growing deficit item and is likely to increase.
- Private capital flows have also become problematical. Canadian investment abroad is rising rapidly, partially reflecting uncertainty over federal government policies, the national deficit, and the value of the Canadian dollar. Foreign investment in Canada is expanding less rapidly than in the past because of Canadian takeovers and the uncertain economic and political outlook. However, the deterioration of the capital flow balance that has occurred in recent years may be at least partially reversed in the 1980s by sizable inflows of foreign capital to help finance major energy projects.
- The Canadian government and Canadian enterprises have favorable access to foreign capital markets and should be able to finance

even somewhat larger deficits on current account during the next several years, if necessary. However, a continuation of the trend toward ever-increasing payments deficits may lead to reluctance on the part of foreign lenders to continue to supply capital on favorable terms.

- Federal policies are expected to be aimed at preventing greater deterioration in the balance of payments. This generally implies encouraging wage restraint and peaceful labor relations and otherwise seeking to encourage the expansion of private investments and to limit inflation rates to U.S. levels or lower. Emphasis will also be placed on encouraging exports and expediting large energy projects expected to attract foreign funding. Exports of gas and electricity may be expanded if balance of payments pressures remain severe.

4. Exchange rate policy will seek to stabilize the value of the Canadian dollar at present levels and to counter speculative movements associated with the uncertainties of large capital projects. If adequate stability is not restored to the long-term balance of payments, however, exchange rates will be allowed to drift downward.

5. Inflationary pressures, balance of payments deficits, and commitments to restructuring federal-provincial relations will limit major federal initiatives in expenditure or tax changes. Federal budgets are likely to continue to be in deficit for some years, only partially offset by provincial surpluses.

6. Domestic and foreign trade barriers will be gradually reduced over the next 10 years. Trade barriers erected to protect labor-intensive industries from foreign competition will be gradually phased out and will be replaced by adjustment assistance to depressed geographical regions.

7. The issue of federal-provincial relations will be periodically bargained over and modified, but never fully resolved.

- The threat of economic and political fragmentation of Canada raised by Quebec nationalist aspirations and by federal-provincial differences over resource revenues may continue.

- Changes in federal-provincial relations over the next 2 or 3 years may enhance provincial authority and participation in activities previously largely under federal control.
- These changes in federal-provincial relations will result in modification of federal policies and regulations in ways that will partially accommodate long-standing economic concerns of the western provinces vis-a-vis the eastern part of the country.

# VOLUME II
## CHAPTER III

## WORLD POLITICAL OUTLOOK

## III WORLD POLITICAL OUTLOOK

### Introduction

The 1980s promise to be one of the most perilous decades since the peak of the Cold War. Of overriding concern is the deterioration of relations between the superpowers and the continuing dependence of the world economy on the fragile stability of the Middle East. Not all geopolitical indicators are negative, however. There are prospects for improved political stability in East Asia and continued economic growth in this rapidly developing part of the globe. In other arenas of world politics, change is neither threatening nor particularly promising from the Canadian point of view. There will be some change in relations between industrialized countries and the developing countries, a greater political importance attached to Canadian grain surpluses, and the strong probability of a fundamental change in the triangular relationship among Canada, the United States, and Mexico.

### East-West Relations

The Soviet invasion of Afghanistan in December 1979 was a sharp reminder of the continuing centrality of power relationships in international politics. The expansion of Soviet power--whether motivated primarily by offensive or defensive considerations--increases the likelihood of a direct military clash between the United States and the USSR, which could escalate from a regional to a global conflict. At the same time, the Russian move demonstrated the extent to which the world economy

depends upon the U.S. geopolitical position in the Middle East. A further deterioration of that position, such as a major reorientation of foreign policy by Saudi Arabia, could lead to a number of immediate adverse economic consequences, including lowered confidence in the U.S. dollar, a cutback in Middle Eastern development plans, and a new spiral in oil prices. The Soviet presence in Afghanistan gives Moscow a club to threaten a weakened Iran and the oil producing countries of the Gulf's south shore as well as a base for supporting separatist movements in both Iran and Pakistan.

In the 1980s, the international system will be dominated by the U.S.-Soviet relationship as it has been since the late 1940s. Although it is true that international politics has become increasingly multipolar, with Japan, the leading countries of Western Europe, and the oil states of the Middle East assuming leading roles in world affairs, the central strategic balance between Moscow and Washington remains essentially bipolar. At the present time, a condition of rough parity can be said to characterize the central balance, but disquieting trends threaten to tip the balance in favor of the USSR and its allies in the 1980s as the USSR augments and modernizes its strategic forces and improve its capabilities for projecting conventional forces to distant parts of the globe.

The Deterioration of Detente

U.S.-Soviet relations have been deteriorating since the 1972 Moscow summit at which the first SALT accords were signed. Over the past 8 years, thoughtful Americans have grown dubious about the prospects for detente and increasingly concerned about the pace and scope of the Soviet buildup of strategic and conventional arms and the extent of Soviet

penetration of the Third World. The Russians, on the other hand, have their own reasons for disappointment with detente. The amount of technology supplied by the United States has been well below Soviet expectations. The United States has not conferred most-favored-nation-status on the USSR, nor has it provided the Russians with long-term financing for imports. Washington's recent preoccupation with human rights and the insistence of the U.S. Congress that closer U.S.-Soviet economic ties are dependent on altered Soviet behavior—both at home and abroad—have also angered the Soviet leadership.

The outlook for the 1980s is for strained relations between the United States and the USSR. Even if the U.S. Senate were to eventually ratify the SALT II agreement, it is clear that arms control has lost whatever momentum it ever had. Although relations between the superpowers need not deteriorate to the level of Cold War confrontation, the accent will be on competition rather than cooperation.

The Balance Shifts Toward Moscow

As former U.S. Secretary of State, Henry Kissinger, has warned, the early 1980s can be an extremely dangerous time. By then, many Soviet strategic military programs, none likely to be constrained by SALT agreements, will be nearing completion, and at that time the U.S. land-based nuclear deterrent, consisting mainly of Minuteman intercontinental ballistic missiles, will be vulnerable to a Soviet first strike. In addition, the USSR's modernization and expansion of conventional arms, along with supporting airlift and sealift capabilities, will make it more difficult for the western powers to counter Soviet pressure in

regions of great strategic importance, such as the Middle East. The Rapid Deployment Force that is now planned in Washington will not be operational until 1983-1984.

The shift in the central balance of power in Moscow's favor is only one aspect of apparent American decline. The weakness of the dollar on international money markets is a constant reminder that the United States has lost its margin of economic superiority over its commercial rivals and is currently unable to reduce its dependence on foreign oil or curb inflation.

The United States has also shown itself to be depressingly unsuccessful in providing timely assistance to friendly regimes and client states. The swift collapse of the Shah's regime in early 1979 came as a shock to the Saudis, who blamed America not only for failing to support the Shah at critical points in the Iranian conflict, but also for its timid and ineffective response to Soviet activity in South Yemen and the Horn of Africa.

At the same time that Washington appears unable to effectively support its allies, the Russians have demonstrated a willingness to advance their interests and those of their Third World clients by force of arms. In the Angolan civil war (1976), the Ethiopian-Somali conflict (1978), the coup in Afghanistan (1978), the Vietnamese invasion of Cambodia (1979), and in the recent occupation of Afghanistan, Moscow demonstrated a willingness and a capability to intervene in local conflicts. Rightly or wrongly, the image is growing, especially in the Middle East and Africa, of an America in retreat and a Russia on the march.

Reversing the Trend?

Gradually, however, a consensus is building in the West that the Soviet challenge must be met. In December 1979, the North Atlantic Treaty Organization (NATO) nations agreed, with Belgian and Dutch reservations, to build and deploy a new generation of long-range missiles to counter the growing threat of the USSR's new SS-20 force. In the wake of developments in Iran and Afghanistan and attacks on American embassies, U.S. public opinion surveys indicate growing concern about the global balance of power and willingness to increase defense spending. Calls for increased defense expenditures have been enthusiastically received, and many American leaders are urging even stronger steps to improve American preparedness.

Yet even a renewed commitment by the United States to pursue its global interests will not reverse overnight the trends of recent years. The augmentation and modernization of U.S. forces will require time and a lot of money. According to the U.S. Central Intelligence Agency, Soviet military expenditures in recent years have been 25% to 45% greater than those in the United States. The Russians spend three times more than the Americans on strategic arms and one-third more on general-purpose forces. The cumulative effect of this effort will be felt in the early 1980s, probably peaking about 1982-1984. No one can say with assurance that the post-Brezhnev leadership in the USSR will use its military advantage to support a more aggressive foreign policy, but current Russian actions in South Yemen and Afghanistan strongly suggest a thrust toward the Persian Gulf and the Arabian Peninsula that may accelerate in the years ahead.

Strained relations between Moscow and Washington, with the United States striving to close a serious military gap in the early 1980s, will have the effect of strengthening NATO and increasing defense cooperation, especially among the leading powers of NATO Europe--Britain, France, and West Germany. In these years, the allies of America and indeed the entire world will be adjusting to an international system in which the power and perhaps even determination of the United States to resist Soviet adventurism will be questioned. This prospect underscores the importance of the relationship between the international strategic balance of forces and economic prosperity, which is, unfortunately, all too frequently overlooked. The postwar military and economic dominance of the United States, for example, was not only coincident with, but also largely responsible for, the economic recovery of Europe and Japan and also the unprecedcnted expansion of multinational corporations in the 1950s and 1960s. If there is a sharp decline in U.S. power and influence in the 1980s, the consequences of that decline will be felt directly in the international economy.

The Volatility of the Middle East

As the Iranian crisis has again demonstrated, the countries of the industrialized West (as well as most of the developing countries) remain dangerously dependent on OPEC oil, particularly on the output of the countries in the Middle East and North Africa. Over the time horizon of this study, such dependence cannot be reduced substantially.

The ability of western economies to reduce oil demand quickly and share losses in an emergency could not long delay sharp drops in economic production and employment were all of OPEC, or even the major Arab producers, determined to cause them. Neither energy conservation schemes, nor stockpiles, nor the International Energy Program would be sufficient to curb them. True, the leading oil-producing countries have little reason to dislocate western economies, given the interdependence that links producing and consuming countries. Nevertheless, governments do not often act in accordance with accepted international economic theory, especially in the Middle East, and western oil dependence gives the Arab producers, which occupy a pivotal position in OPEC, the ability to restrict or cut off oil supplies should it appear politically advantageous to do so.

The volatile character of Middle Eastern politics intensifies the seriousness of the related problems of western oil-dependence and Soviet military expansion. In the 1980s, regional tension will result principally from the Arab-Israeli conflict, but other sources of conflict abound:

- The internal political fragility of the oil states of Arabia that are militarily vulnerable, populated with large numbers of foreign workers, and profoundly affected by the currents of pan-Arabism and Islamic revival.
- Iran's "unfinished revolution" and the likelihood of civil war, ethnic revolts, and possibly superpower intervention in that country.
- Traditional-radical splits in the Arab world.
- Regional rivalries, such as the long-standing competition between Iran and Iraq.
- Sunni-Shiite tensions in Iraq, Syria, Bahrain, Kuwait, and the UAE.

- Massive transfers of sophisticated armaments to several regional actors.
- The activities of revolutionary groups (e.g., the Palestine Liberation Organization and the Popular Front for the Liberation of Oman).
- The regional potential for nuclear proliferation.

In short, the most likely outlook for the Middle East is one in which conflict is not only possible but also likely. In view of western oil-dependence, the sources of political instability in the region, and the political leverage held by the Arab oil producers, interruptions in the supply of oil and periodic step increases in oil prices are highly probable.

Developments in the Pacific

East Asia--from Japan and South Korea in the north to Australia and New Zealand in the south, and from Thailand in the west to the Philippines and Indonesia in the east--will be a region of expanding significance and influence in the 1980s, particularly for those countries, like Canada, bordering on the Pacific basin. Prospects for political stability and economic health in East Asia are attractive. Political conditions contributing to this favorable outlook are twofold: first, an emerging community of interest among China, Japan, the United States, and the five countries of ASEAN to contain the influence of the Soviet-Vietnamese axis; and second, China's commitment to the "four modernizations" (industry, agriculture, science and technology, and national defense) that is likely to survive changes in the Chinese leadership.

The prospect of growing political stability in Asia is suggested by several factors, including China's rapproachement with Japan and the

United States, its downgrading of the Taiwan issue, and its improved relations with the ASEAN countries. The commitment to modernization is not just confined to Chairman Deng Xiaoping and his immediate circle, but is widely shared at the top of the Chinese Communist Party.

Commitment to the four modernizations implies a growing volume of trade with the West, joint ventures with multinational corporations, and the development of China's oil and mineral resources to finance imports. At the same time, the modernization of China will be subject to various constraints, such as the availability of foreign exchange, investment capital, and skilled labor. In the foreign policy arena, China can be expected to avoid any direct clash with the USSR, but at the same time to resist Vietnamese attempts at hegemony in Indochina. In addition, China will almost certainly press its claims to the disputed waters of the South China Sea where offshore oil prospects are believed to be good.

In the 1980s, Japan can be expected to enjoy a higher political-military profile than is currently the case. The Japanese will look to the United States to counter Soviet adventurism in Asia, but some growth in the Japanese Self-Defense Forces, particularly the naval arm, is highly probable. Factors favoring a gradual buildup include: Japanese concern over the scheduled withdrawal of U.S. forces from Korea, Soviet pressure in the Kurile Islands controversy, the need to protect Japan's sea-lanes to the Persian Gulf, and domestic pressure to compete in the international arms market.

North-South Relations

Calls for a new international economic order (NIEO) will continue to serve as a rallying point for Third World countries, but the cohesion uniting the developing world, which is already fragile because of the disparate political, economic, and social organization of the countries, will deteriorate even more in the 1980s. Oil producing countries, newly industrializing countries (NICs), such as South Korea and Taiwan, and other rapidly-developing or comparatively well-endowed Third World countries will increasingly view their interests as requiring closer ties to the developed countries.

At the same time, slow growth in most of the developed world, nagging unemployment, inflation, and high-cost energy will keep governments in the industrial countries focused on the solution of domestic economic problems. Protectionist sentiment can be expected to increase as industrial and labor leaders argue for more and more government help in meeting the challenge of foreign competition, particularly from the NICs. Enthusiasm for global redistribution schemes, never great anyway, will be minimal in the industrialized countries.

Fragmentation of Third World unity and increasing concerns about the domestic economies in the industrialized countries will not, however, remove the rhetorical appeal of the NIEO. Calls for a more equitable sharing of wealth between rich and poor countries will require some kind of response from the developed world. In the industrialized countries, a consensus will begin to emerge as to appropriate levels of assistance to the Third World, but whatever consensus develops it is unlikely to satisfy the demands of Third World elites. As a result, Canada, among

others, may face increased international pressure on selected issues, such as making more of its grain production available for emergency aid, or easing restrictions on imports from developing countries.

Another Third World trend that may have relevance for Canada is the political climate for investment in mineral-bearing developing countries. Third World governments have taken an increasingly proprietary interest in control over natural resources in the past two decades. The result has been that mining companies have reduced their exposure in developing countries and increased investment in politically safe countries like Canada. In the 1980s, however, it is likely that the capital-short developing countries will reduce restrictions on foreign investment and adopt a more pragmatic posture toward multinational corporations. Thus, some capital investment in metallic mineral development that might otherwise have been made in Canada could be diverted to the mineral-rich developing countries.

Transnational Problems

Many of the so-called transnational problems of the 1980s, such as nuclear proliferation or terrorism, are unlikely to touch Canada directly. An exception, however, is food self-sufficiency that is likely to present a serious challenge to Third World leaderships. The techniques of agribusiness will be applied to export crops, thus increasing the overall amount of food production in the world, but problems of distribution could be acute. The grain surpluses of the developed countries (mainly the United States, Canada, and Australia) will take on additional political importance. None of these countries is likely to use food as

a weapon, but the very possibility of such an option will confer on them additional political leverage in world affairs.

The 1980s will also witness increasing contention over claims to territorial waters as oil, offshore minerals, and fisheries take on even more importance in the decade ahead. Canada is already embroiled in a dispute with the United States over The Georges Bank, and similar types of disputes are possible between Canada and Japan or Canada and the USSR. Claims and counterclaims to control of the South China Sea involving China, Vietnam, Taiwan, Indonesia, Malaysia, and the Philippines may not only delay production from new offshore oil finds in the decade ahead, but also delay or impede East Asian political and economic cooperation on other matters.

The North American Triangle

U.S.-Canadian economic relations will grow even closer in the 1980s. At the same time, U.S.-Mexican relations also will deepen. All three countries will indeed share parallel interests on a range of economic issues, and a number of bilateral arrangements may be made. But nothing approaching a North American "Common Market" is likely to emerge in the 1980s. Both Canadians and Mexicans will tend to dismiss such talk as political rhetoric (which most of it is) or regard it suspiciously as an American scheme to ensure access to fossil fuels or seize control of their industries. What will be important to Canada in the 1980s is the kind of a relationship that develops between the United States and Mexico.

Canada and the United States are tied by geography, history, language, political values, and economics. The two countries are NATO allies. Each is the other's principal trading partner. Canadians and Americans

travel freely across their common border. True, strains often show in the relationship, but by and large relations are excellent.

In the 1980s, Washington will be increasingly concerned with Mexico. America needs Mexican gas and oil to reduce its dependence on Middle Eastern and North African oil. At the same time, the Mexican-American community, not heretofore an important political force in U.S. domestic politics, will begin to make its influence felt, particularly in California, Arizona, New Mexico, Colorado, and Texas. Finally, Washington will be anxious to win Mexican support in stabilizing the growing political unrest in Central America, exemplified by the triumph of the Sandinistas in Nicaragua and the current turbulence in El Salvador.

On the other side of the coin, the United States holds the key to many of Mexico's problems:

- A liberal U.S. immigration policy is vital to Mexico's plans for modernization because the flood of illegal aliens into the United States represents a safety valve for Mexican population pressures.
- Lower U.S. trade barriers against Mexico's farm products would increase that country's agricultural exports.
- The movement of U.S.-based multinational corporations into Mexico has absorbed some of the country's chronic unemployment and can be expected to create even more jobs in the future.
- Roughly one-half of Mexico's foreign debt is owed to U.S. bankers.
- Recovery of Mexican oil--currently an expensive process--could be greatly hastened by technical assistance from U.S. oil companies.

Given the obvious advantages to both countries in developing closer economic ties, it is unlikely that Mexico would join OPEC even though its own oil prices will be linked to OPEC prices. Economic ties to the United States are so overwhelmingly important to Mexico that a nonaligned foreign policy does not appear realistic. Nevertheless, Mexico will find

it expedient to adopt "anti-American" positions on some issues, either to defuse domestic criticism or influence Third World leaderships.

The significance of all this for Canada is that Mexico's increasing importance to the United States will alter the long-standing Canadian-American tie. The way in which this will happen is as yet unclear. But it will be increasingly difficult for the United States to make deals with Canada that are perceived to be on a more preferential basis than those concluded with Mexico. Washington will be increasingly concerned with demonstrating an even-handed policy toward its neighbors to the north and south. Despite its close security ties to Canada, the American political leadership will bend over backward to avoid abrading Mexican sensitivities or offending the increasingly vocal Mexican-American community. In the course of such exercises, Canadians may see themselves "taken for granted" by the United States. Even if such a perception is not always accurate, it will unquestionably be an irritant in U.S.-Canadian relations.

# VOLUME II
## CHAPTER IV

## WORLD ECONOMIC OUTLOOK

# IV WORLD ECONOMIC OUTLOOK

## Introduction

In retrospect, the first half of the 1970s marked the end of the golden era of post-World War II economic expansion. The 1950s, 1960s, and the first 3 or 4 years of the 1970s were a period of very rapid economic growth for almost every country in the world. But beginning in 1971 and 1972, several fundamental economic problems started to emerge, particularly in the industrialized countries. Rapid expansion of government spending, lax monetary policies, and booming economies led to a surge of inflation in 1972 and 1973. This was exacerbated by strong increases in the prices of most commodities on world markets and was capped by the quadrupling of oil prices in late 1973 and early 1974.

As a result, in 1974 and 1975 the world economy plunged into its worst recession since the 1930s. In the 5 years since the bottom of the recession, most countries have been plagued by slow economic growth, persistent inflation, weak capital investment, and high levels of unemployment. In many countries, some modest progress was made in dealing with these problems in the 1976 through 1978 period, but the resurgence of inflation, doubling of oil prices, and growing instability in the Middle East, all of which occurred in 1979, have set back the world economy roughly to where it was 5 years ago. Therefore, the second half of the 1970s has been a period in which little or no net progress has been made toward solving the fundamental long-term economic problems of the world and reestablishing a stable environment for economic growth.

Overview of the Economic Outlook

Against this backdrop, two characteristics will dominate the global economic environment during the next 15 years. First, the fundamental economic problems that have proved to be so intractable during the past 5 years will continue to prevent a return to a strong and stable world economy for many years to come. Second, the magnitude of these problems, coupled with the deteriorating stability of the world order and the particularly worrisome potential for troubles in the Middle East, combine to create a greater uncertainty over the outcome of future events and their consequences than has been the case since the early 1950s.

As an indicator of future economic conditions, Table 1 presents historical and projected growth rates of real GNP for several individual countries and groups of countries. For the world as a whole, economic growth in the next 15 years is expected to be far below that experienced in the 1950s and 1960s although about the same on average as in the 1970s. For all but the OPEC countries and the United States, growth is expected to be weaker in the first half of the 1980s than in the 1985-1995 period. This is largely attributable to the poor growth prospects in most countries in 1980 and 1981. In addition, inflation and energy problems are expected to be somewhat less serious in the second half of the 1980s, and thus their adverse impact on economic growth will be reduced.

Before discussing the outlook for these key countries and regions, it is useful to survey some of the broad international forces that will shape the future of the world economy. The three subsections below discuss the basic factors that contribute to economic growth, global resource constraints, and several important economic problems that the

industrialized and the developing countries face in the next decade and a half.

Table 1

AVERAGE ANNUAL GROWTH OF REAL GROSS NATIONAL PRODUCT
(Percent)

| | 1950-1960 | 1960-1970 | 1970-1980 | 1980-1985 | 1985-1990 | 1990-1995 |
|---|---|---|---|---|---|---|
| Canada | 4.6 | 5.2 | 3.9 | 3.4 | 3.6 | 3.5 |
| United States | 3.3 | 3.9 | 2.8 | 3.1 | 3.1 | 2.9 |
| Japan | 7.9 | 11.1 | 5.3 | 4.5 | 5.0 | 4.6 |
| Western Europe | 4.6 | 4.8 | 2.9 | 2.9 | 3.1 | 3.0 |
| OPEC | 6.0 | 8.0 | 7.6 | 6.6 | 6.2 | 6.0 |
| Developing countries | 5.8 | 6.4 | 5.5 | 4.6 | 5.1 | 4.8 |
| Centrally planned economies | 4.7 | 5.2 | 4.4 | 3.8 | 4.2 | 3.9 |
| World average | 4.9 | 5.3 | 3.9 | 3.7 | 3.9 | 3.8 |

Sources of Economic Growth

In a basic conceptual sense, real economic growth arises from increases in the level of employment coupled with increases in the amount of output produced per employee. Growth in employment will vary considerably from country to country. In some northern European countries where population growth has slowed to very low rates, additions to the labor force will be small. In the United States and Canada, increases in employment, which were very rapid in the 1970s as a result of large numbers of young people and women entering the labor force, will be much more moderate in the 1980s. In many developing countries, however, the fast pace of population expansion during the past two decades will lead to a fairly strong increase in employment levels in the future. As a general rule, an expanding work force will contribute about one-third of overall economic growth in most countries. For some countries, then,

the modest economic growth prospects result partly from anticipated weakness in employment growth.

Of greater importance, however, are changes in output per employee, or productivity gains. Studies indicate that several major factors contribute to improvements in productivity. One factor is increases in the quantity of capital used per employee. A second is the level of education of the labor force. A third, often termed "advances in knowledge," encompasses a number of elements from basic and applied scientific knowledge to improved management techniques. A fourth is more efficient resource allocation, consisting largely of the migration of labor from the agricultural sector, where many people are typically underemployed, to the manufacturing and service sectors. A final factor of significance is the achievement of greater economies of scale through the establishment of larger production units.

For the industrialized countries, considerable potential for productivity gains exists, but prospects are not nearly as attractive as in the 1950 and 1960s. In virtually every developed country, the percentage of GNP devoted to capital investment has slowed substantially during the past 6 years. Given the expectation of an uncertain economic environment in the years ahead, capital investment rates are likely to remain somewhat weak. In addition, the need to devote considerable capital resources to nonproductive investments, such as pollution control and safety expenditures, will further erode the impact of investment on productivity. The educational level of the labor force may also make a contribution to improved productivity, but clearly the major gains in this area have already been realized in the developed countries. Advances in knowledge should continue to be a major spur to productivity.

Although spending on research and development has fallen somewhat as a percentage of GNP in most countries in the past decade, the pace of advancement in many scientific and technological areas, such as microelectronics and biochemistry, remains quite strong. Finally, as in the case of improved educational levels, both more efficient resource allocation and greater economies of scale are likely to make only marginal additional contributions to productivity gains, having largely exhausted their potential during the past 50 years of industrialization in the developed countries.

The outlook for productivity growth in the developing countries is considerably brighter. Capital investment rates, funded by both domestic capital and foreign investment, should be as strong as in the past in most countries. Advances in knowledge, most of which are in the form of imported technology, should also be a major positive factor. Substantial room for improvement exists in most developing countries for improved education of the labor force, more efficient resource allocation, and greater economies of scale in both manufacturing and agriculture. Prospects for fairly strong productivity gains in developing countries largely account for the fact that economic growth in these countries in the 1980s is expected to be only slightly slower than during the prior three decades. In the industrialized countries, by contrast, the sharp decline of projected growth in the 1980s in comparison with that in the 1950s and 1960s is largely attributed to less favorable expectations for productivity growth.

## Resource Constraints

### Energy

The crux of the energy problem in the future, as during the past 5 years, is the cost and security of supply of oil. After the jump in oil prices in 1973 and 1974, economic growth throughout the world slowed greatly, reducing the demand for OPEC oil. It was actually not until 1978 that OPEC oil production again reached the level achieved in 1973. As a result of this reduced demand, from 1974 to 1978 the price of oil on world markets declined by about 15% after adjusting for inflation.

The recent revolution in Iran caused a temporary reduction in OPEC oil production of more than 10% and what may be about a 7% reduction in the long term (assuming a continuation of current policies). The cutback in output from Iran in 1979 was partially offset by higher output from other countries, but the net result was still a significant tightening of the world oil market. This supply-demand imbalance pushed up prices on the open market and allowed OPEC to drastically increase its posted prices for the second time in 5 years.

Setting aside political considerations for the moment, there are purely economic reasons to suggest that over the next several years the real price of oil should stabilize or even decline, as occurred in the 1974-1978 period. Worldwide economic growth is expected to be weak at least during the next 2 years and will be only moderately strong at best thereafter. Combined with new efforts to conserve energy in response to higher energy costs, total energy consumption will probably increase by only about 2.5% per year through most of the 1980s. At the same time, nonoil energy supplies should begin to expand more quickly as coal and natural gas resources are developed. Non-OPEC oil supplies, largely

from Mexico and the North Sea, will also increase significantly in the next 5 years. The net result should be a relatively constant level of demand, or perhaps a 1% or so annual rate of growth, for OPEC oil. Under ordinary circumstances, this should not be sufficient demand pressure to lead to major price increases.

Unfortunately, however, oil prices are not dictated solely by economic forces. As indicated in Section III, the Middle East will remain an unstable region in the 1980s. There are a number of potential developments that could lead to a significant oil supply interruption and another leap in oil prices. Many of these arise from the growing conflicts in most of the major countries of the region, whereas others derive from external forces.

In addition to these noncontrollable threats to future oil supplies, the OPEC countries may also find it in their interests to voluntarily reduce their oil production levels. As a result of the doubling of oil prices in 1979, several OPEC countries will accumulate vast sums of surplus wealth over the next several years. By the mid-1980s four countries--Saudi Arabia, Kuwait, the United Arab Emirates, and Qatar--will be receiving in excess of $20,000 per capita per year from oil exports. Their accumulated surplus funds on a per capita basis will range from $50,000 to $100,000. Visible wealth of this magnitude is likely to make the leaderships of these countries increasingly vulnerable to both internal and external subversion. In addition, these financial surpluses will of necessity be invested in the western countries, primarily Europe and the United States. Middle Eastern investments in the West in recent years have been subject to erosion from inflation and interest rate and exchange rate changes. As a result, it may be

increasingly attractive for these four OPEC countries, which account for almost one-half of OPEC's production, to keep more of their oil in the ground rather than exchange it for financial investments that are beyond their control and are of uncertain value.

After all the potential disruptions to oil supplies are taken into account, it seems likely that some event or combination of events in the next several years will provide OPEC with another opportunity to sharply raise oil prices. This may well be repeated on other occasions during the 1980s and early 1990s. It is impossible to identify with any accuracy what the net impact of these developments will be on future oil prices. It is assumed, however, that over the 1980-1995 period as a whole, the price of oil will rise at an average annual rate of 2% in real terms.

Minerals

The outlook for the availability and prices of minerals differs for each commodity. Several conditions, however, indicate that in general minerals will be available in adequate quantities at average real prices not greatly different from those of present levels. First, with a few exceptions, minerals are abundant in the earth's crust. In the industrialized countries during the past 30 years or so, a shift away from domestic sources to increasing dependence on imported minerals from developing countries has occurred. For the most part, however, this has not been a result of resource depletion in the industrialized countries. The easily exploitable deposits in the developed countries have been largely exhausted, but a substantial resource base remains. Production gradually shifted to the developing countries because the inexpensive

and easily developed ore bodies there were untapped. At the present time, however, exploration, development, and transportation costs in the developing countries have risen substantially, along with political risks in many cases. As a result, development of some of the remaining resources in the industrialized countries--particularly in Canada, the United States, and Australia--is becoming more attractive. The industrialized world will certainly continue to be a major net importer of raw materials, but the existence of extensive reserves that can be exploited in the developed countries at costs not much above current prices will act as a constraint on the magnitude of future price increases by the developing countries.

In addition, it will be difficult for mineral exporting countries to isolate themselves from market forces by constraining aggregate production or by artificially raising prices. Virtually all the conditions that contribute to the success of the OPEC cartel in controlling world oil prices are absent from other major commodities: a homogeneous product, a small number of countries that control a large share of the world's reserves, production costs that are well below those of substitute commodities, political and economic homogeneity of at least some of the producing countries, and the presence of one large producer who is willing to vary production to offset swings in market demand.

Agricultural Commodities

On a global basis, the outlook for the aggregate availability of food over the next decade and a half is highly uncertain. Concerns have been raised with increasing frequency in recent years that widespread food shortages will occur in the 1980s and beyond. The world

food supply is obviously greatly dependent on weather conditions, which are unpredictable in the long term.

Aside from weather conditions, however, several factors suggest that fears of large-scale food shortages may be overstated. First, the rate of population growth has slowed dramatically in the industrialized countries in the past 5 to 10 years, and there are indications in the past few years that a similar trend may have begun in a number of developing countries.

Second, the green revolution, which has been introducing new varieties of grains to the developing world, has a great deal of expansion potential left. In some regions, resistance to using the new grains is being overcome only slowly and in other areas newer strains have been developed to replace earlier ones that failed to live up to their promise.

Third, greater emphasis is being placed on development of the agricultural sector in many developing countries (and also the USSR) in an attempt to reduce dependence on uncertain and expensive imported food. The trend toward greater mechanization of agriculture in the developing countries and the farming of more economically sized plots will lead to higher yields. Greater emphasis will also be placed on improving the infrastructure of the food system to reduce the wastage caused by insufficient storage facilities. Truck and rail systems will be upgraded so as to get the products to market before they spoil. Finally, considerable expansion potential exists for increasing the amount of land under cultivation around the world. Greater use of fertilizer and more irrigation can make sizable areas of land that are presently not in use productive.

These factors indicate that total world food production during the 1980-1995 period may keep pace with population growth. This does not imply, however, the absence of food problems everywhere. The poorest countries, particularly those in sub-Saharan Africa, have the least promising prospects for rapidly improving their production. At the same time, these countries typically have the highest population growth rates and are the least able financially to purchase agricultural commodities in world markets. It is likely, then, that bilateral and internationally sponsored food assistance programs will continue and expand in the 1980s, despite a somewhat favorable world food outlook.

Export markets for agricultural products are likely to continue to grow although perhaps not as rapidly as during the past decade. Any improvement in the global food supply-demand balance will be only gradual at best. At the same time, as living standards improve throughout the world, per capita food consumption will increase. Perhaps more importantly, expanding income levels in the developing countries can be expected to produce an upgrading and diversification of diets. Thus, demand for nonindigenous commodities such as wheat may increase significantly, particularly in rapidly growing regions such as East Asia.

Other Constraints on Growth

The list of threats to the growth potential of the world economy is dominated by uncertainty over the supply and price of Middle Eastern oil. Beyond energy considerations, however, several other fundamental long-term problems are likely to have an adverse impact on the economies of most countries. Three of these problems are particularly troublesome for the industrialized countries: inflation, restricted economic

incentives, and declining basic industries. Two others affect many of the developing countries: balance of payments deficits and political instability.

Inflation

The problem of inflation in the industrialized countries has closely paralleled the energy problems in the last decade. In the early 1970s, inflation began accelerating dramatically in virtually every industrialized country, reaching a peak in 1974. From 1975 through the first half of 1978, inflation rates slowed significantly everywhere and appeared to be leveling off at rates that were high by historical standards but still tolerable in terms of their economic impact. However, in the second half of 1978 and continuing through 1979, inflation again accelerated greatly everywhere.

It is important to note that both in the early 1970s and more recently, the upsurge in inflation preceded the increase in world oil prices. Thus, although higher oil prices certainly added to the already existing inflationary pressures, OPEC is not the major cause of inflation in the developed countries. Inflation arises from fundamental structural problems within the industrialized economies, and the lesson of the past 8 years or so is that little progress has been made in solving these structural problems.

Moreover, most governments have relatively little flexibility to take major policy initiatives to deal effectively with inflation. With high unemployment rates, weak economic growth, heavy tax burdens, and fragmented political support endemic in the developed countries, only a very few have the ability to extensively pursue the conservative policies

necessary to bring inflation under control in the longer term. As a result, a continuation of the relatively ineffectual policies of recent years is probable in most of the industrialized world. Inflation will remain a major problem and an impediment to economic progress.

Economic Incentives

The key to economic growth in every industrialized country in the free world is private enterprise. But during the past 5 to 10 years, incentives for the pursuit of private economic gain--and thus growth--have undergone considerable erosion in many countries. Probably the best indicator of this is the marked deterioration experienced in business profits in the 1970s throughout the industrialized world. As a percentage of GNP, retained earnings of the business sector in the United States dropped from 3.3% in the first half of the 1960s to 2.9% in the second half and fell further to about 2.0% in the 1970s. The decline was even greater in the United Kingdom (5.7% in the first half of the 1960s, 3.0% in the second half, and less than 2.0% in the 1970s) and in Germany (5.9%, 4.2%, and 2.5%). A similar but less severe downward trend has also occurred in France, Japan, and a number of the smaller European countries.

Declining profitability has many causes, but one constant factor across most countries has been the growing encroachment of government on the private sector. The most direct manifestation of this has been the enormous proliferation of government regulations that constrain almost all private economic activity. In addition, the growing size of the government sector and its dominance of the capital markets inhibits the ability of businesses throughout the industrialized world to fund their longer term expansion plans.

It is clear that economic progress in the developed countries requires a healthy business sector. The prime contributors to growth are innovation, research, and investment, and these flourish in an environment that permits the relatively unconstrained pursuit of profits. But the long-term decline in profitability and the weakness in capital investment in most countries during the latter half of the 1970s indicate that private economic incentives are significantly weaker than in the past.

There has been some evidence in the past year or two to indicate that a realization of the need to restore private economic incentives may be spreading in a number of countries. Government policies to reduce the regulation of the private sector and enhance incentives for capital investment have been implemented or proposed in Great Britain, France, West Germany, and the United States. The issue of revitalizing the private sector has also been raised in Canada and Sweden. Thus far, however, the actual impact of all this activity has been minor. A very fundamental change will be required to restore the vigor that characterized the developed countries in the 1950s and 1960s.

Declining Basic Industries

The industrialized countries are beset with major structural problems in a number of basic industries--the same industries that have contributed greatly to economic growth in the past. The lagging performance of these industries, including steel, textiles, clothing, shipbuilding, and synthetic fibers, has prevented the modest economic recovery of the past 4 years--particularly in Europe and Japan--from being as vigorous as could be expected, given the severity of the 1974-1975 recession. Moreover, these industries account for a substantial share of employment in the

industrial sector, and their weakness has contributed greatly to the record unemployment rates that exist in many countries.

The fundamental causes of these problems are twofold. First, the economies of the industrialized countries have been undergoing a structural transformation during the past decade or so away from heavy industry and toward more knowledge-oriented and service industries. Thus the long-term growth rates for most of these industries have been slowing for some time. Weak economic growth since 1974 also had a severe impact on demand.

Second, the industrialized countries have been facing increasing competition in these industries from the developing countries. Many developing countries have chosen some or all of these industries as major stepping stones in their industrialization programs. This is particularly true of textiles, clothing, and steel industries in many developing countries, but also holds for shipbuilding, chemicals, and synthetic fibers industries in others.

The long-term, as well as short-term, consequences of continued weakness in basic industries of the industrialized countries could be quite severe. At a time when unemployment is very high, a major part of the economies of the developed countries probably cannot be counted on to absorb many additional workers and may in fact undergo further contraction. In addition, the capital already invested in these industries is immense. The reduction of capacity before plant and equipment are physically obsolete--as is presently occurring in steel, shipbuilding, and synthetic fibers in Europe--represents a substantial economic loss.

Other long-term difficulties may arise from the manner in which the problems of these declining industries are being handled, particularly in Europe. Cartels to reduce competition and maintain market shares of individual producers are under consideration in several industries. In others, particularly textiles, clothing, and steel, higher tariffs, quotas, or "orderly marketing agreements" have been implemented to protect domestic producers. In many cases, operating subsidies have been provided. All these actions have one thing in common: they represent government efforts to prevent the normal consequences of changed economic circumstances. In the short term, these efforts may be beneficial. In the long term, there is less reason to be optimistic; such efforts may lead to another major increase in state ownership and protection of inefficient and declining industries.

Balance of Payments Deficits

The primary source of balance of payments problems for the developing countries, as well as for the developed countries, is the large increases in oil prices in 1973-1974 and 1978-1980. The combined balance of payment deficit for the non-OPEC developing countries increased from a relatively modest $10 billion in 1973 to an average of about $30 billion per year in the 1974-1978 years. The doubling of oil prices in 1979 pushed this deficit to an estimated $40 billion, and a further increase to $50 billion or more is likely in 1980.

For most countries, these deficits may be difficult to reduce anytime soon. In the past 5 years, the developing countries have not participated proportionately in the great expansion of goods and services exported to the OPEC countries. Improvement in the trade positions of

the non-OPEC developing countries depends instead on rapidly growing exports to the industrialized countries. But that in turn depends on an improvement in economic growth in the developed world--the outlook for which is not particularly bright. Furthermore, the exports of the developing countries tend to be concentrated in raw materials and basic commodities that are subject to rather violent fluctuations in demand and price.

In addition, most of the developing countries also bear the burden of a large foreign debt accumulated as a result of the deficits of the past 5 years. Interest payments on these debts absorb from 25% to 40% of annual foreign exchange earnings for a number of countries, and part of the principal must be refinanced almost every year. As a result, it is likely that more countries will be forced by the International Monetary Fund and private creditors to undertake severely restrictive economic policies, as has happened in Zaire, Peru, and Turkey in the past 2 years.

Political Instability

As a generalization, the type of political system that exists in a developing country does not seem to have much impact on its long-term economic growth. Mexico has achieved strong growth in the past under a democratic system, Brazil has experienced even more rapid growth under a somewhat benevolent military dictatorship, and Korea had amazing growth under a not-so-benevolent dictatorship. It is apparent, however, that a radical change in the type of government can have a serious impact on the economy that can extend for a number of years. Such changes have occurred in recent years in Chile, Greece, Portugal, Spain, and Argentina. The immediate economic effect in each of these cases was a sharp drop in

GNP. In Greece, the economy stabilized quickly, and fairly strong growth resumed. But in Chile and Argentina, both economies remained weak for several years. Economic recovery in Portugal and Spain has also been fitfull, and prospects for at least the next few years--particularly in Portugal--are questionable.

It is improbable that political instability will greatly affect the average growth rate of many of the developing countries over the next 15 years. But over shorter time periods, a significant imapct may occur. Among the major developing countries, candidates for future abrupt and major changes in government include Yugoslavia, Turkey, Indonesia, Malaysia, the Philippines, and Nigeria.

## Economic Outlook for Major Countries and Regions

These broad-scale observations will influence in varying degrees the economic prospects of each individual country in the world. The countries and regions of particular significance to Alberta include the United States, Western Europe, East Asia, and some of the developing countries. (Economic and political conditions in Canada will be discussed in Section V.)

### United States

The U.S. economy is expected to grow at an average annual rate of 3.0% in real terms in the 1980-1995 period. This is somewhat below the average growth rate of 3.3% per year during the prior three decades, but the discontinuity between past and future growth in the United States will be much less than for any other industrialized country.

The U.S. economy is well balanced and diversified. It enjoys world leadership in many of the high-technology industries that will be a major source of growth in the developed world. The agricultural and service sectors are quite healthy, and the manufacturing sector at least is not as burdened by stagnant basic industries as are many other countries.

The United States does, however, face several major problems that will have an adverse impact on future growth. Inflation is currently running at the highest rate in the country's peacetime history. Combined with a weak economy in 1980 and high unemployment, the chances of firm government policies to combat inflation are not high. Thus, the distortions in the economy that are caused by excessive inflation are expected to persist for a number of years.

A second major problem has been the very poor performance of productivity in recent years. Since 1974, productivity increases have averaged less than 1% per year. A major cause of this anemic performance has been the enormous addition of people to the employment rolls (over 10 million in the past 5 years), many of whom have been poorly skilled new entrants to the labor force. Weak capital investment has also been a prime contributor to poor productivity.

The outlook for labor demographics is favorable. Fewer new entrants will be joining the labor force in the future, and the most rapidly growing segment of the population will be the highly productive 25 to 44 age group. Prospects for improved capital investment, however, are not as bright. Investment is unlikely to regain its former vigor so long as so many economic uncertainties cloud the future.

Western Europe

The economies of Western Europe are undergoing a painful transition from the very high growth rates of the 1950s, 1960s and early 1970s to much slower growth in the future. Real GNP growth is expected to be about 3.0% per year in 1980-1995, far below the performance of the post-war period as a whole and about equal to average growth during the past 5 years (which is generally viewed as a period of stagnation and malaise). Western Europe is in the process of rationalizing and restructuring many of its heavy industries, but unemployment rates three to four times as high as in the pre-1974 period will make progress toward a more viable economic structure for the 1980s slow.

The economic outlook varies considerably from country to country. The northern European countries--West Germany, The Netherlands, Belgium, and the United Kingdom--face the most difficult adjustment problems. The Scandinavian countries have a natural resource base and small industries that have cushioned their economies from some of the difficulties in recent years. France and the southern European countries--Spain, Portugal, and Greece--have considerably more favorable prospects.

East Asia

East Asia will have the most rapidly growing economy of any region in the world. The dominant economy in East Asia will continue to be Japan's. Although the projected average real GNP growth rate of 4.7% per year in 1980-1995 is less than one-half of the rates achieved in the 1950s and 1960s, Japan will still experience stronger growth than in any other industrialized country. Growth will be fueled by a focus on production of goods and services to meet internal demand, rather

than an emphasis on exports as in the past, and by a concentrated effort to become a world power in high-technology industries.

Barring a reversal of China's recent move toward a more pragmatic political and ideological posture, the Chinese economy should grow very rapidly in the future, at an average annual rate perhaps exceeding 6% in real terms. Because of its low per capita income level and because its economy is largely self-contained, China will not be a major regional economic power until the 1990s at the earliest. Nonetheless, trade with the rest of the world will expand rapidly, and China will be an increasingly attractive market for agricultural products and capital goods.

The newly industrializing countries in East Asia--South Korea, Taiwan, Hong Kong, and Singapore--and several other countries that are less far along in the development process--Malaysia, Indonesia, Thailand, and the Philippines--all have highly favorable growth prospects. Real GNP growth in 1980-1995 will average between 5.5% and 6.5% per year for each of these countries. To varying degrees, these countries are pursuing the same strategy that proved so successful for Japan in the 1950s and 1960s. They are emphasizing rapid expansion of their industrial sectors and pushing exports of low-technology manufactured goods to the vast markets of the developed countries. Some, such as Indonesia and Malaysia, have substantial raw materials to further fuel their development.

The Developing Countries

Outside of the East Asian region, the outlook for the developing countries is decidedly mixed. Some, including Mexico, Brazil, Greece, and perhaps Chile and Egypt, share the same attractive prospects as the

East Asian developing countries. The OPEC countries, too, will have uniformly strong economies, at least so long as they are able to maintain internal political stability.

A number of other developing countries, including most of those in Latin America and a few in Africa, will face a variety of problems that will constrain their growth potential. These difficulties will include balance of payments deficits arising from the high cost of oil imports, endemic inflation and unemployment, a lack of adequate domestic capital, high foreign debt levels, and interral social and political tensions. Despite these problems, economic progress will be moderately favorable, with average real GDP growth rates ranging generally between 4.5% and 5.5% per year.

A final group of countries, including most of those in sub-Saharan Africa and the Indian subcontinent, may encounter increasingly insurmountable difficulties in the next 15 years. The lack of a sufficiently stable social, political, and economic base will continue to frustrate the efforts of these countries to move toward agricultural self-sufficiency and the development of the beginnings of industrialization. Economic growth rates in these countries are likely to average between 3.0% and 4.5% per year, which leaves little room for significant improvements in per capita living standards after adjusting for very high rates of population growth.

## Implications of the World Economic Outlook for Canada

Within this overview of anticipated developments in the world economy over the next 15 years, a number of forces and trends will act as opportunities for, and constraints on, Alberta and the rest of Canada.

## The Postindustrial Economies

The economic structure of the industrialized countries has been in transition for the past decade or more. Economic activity is increasingly focused in the service sector and less concentrated in the production of basic manufactured goods. The trend has been most pronounced in the United States, where the percentage of total employment in manufacturing has fallen from 36% in 1960 to 28% in 1978. In Western Europe, the beginning of this transition was delayed until the 1970s. Throughout the 1960s, the percentage of the European labor force engaged in manufacturing was steady at about 44%. With the mid-1970s recession and the continuing stagnation of some major industries in Europe, this percentage began falling rapidly and reached 40% in 1978.

In all the highly developed countries, the trend away from manufacturing as the dominant economic activity will continue. Manufacturing of basic goods and standard consumer products will increasingly shift to the developing countries. Low wage rates, new production facilities, and fewer regulatory burdens give many of these newly industrializing countries a formidable competitive advantage over the developed countries. As a result, the search on the part of the developed countries for sources of future economic growth will center on services and high technology manufacturing activities, such as telecommunications and electronics. These offer a combination of high-quality employment, relatively low pollution and usage of raw materials, and rapid technological innovation. However, because of their appeal and the relative ease with which high-technology activities can be relocated from one place to another, the competition among countries, and regions within a

country, to become a focal point of these high-growth industries will be intense.

International Capital Investment

The significant slowdown in economic growth in Japan and Western Europe that has occurred since 1974 and is expected to continue may lead to major capital outflows from these countries. Weak growth prospects at home and the declining capital needs of heavy industry have led business and financial institutions increasingly to look overseas for investment opportunities. The developing countries will be major beneficiaries of these capital flows as European and Japanese companies establish manufacturing facilities in the developing countries to serve local markets where growth prospects are bright and to produce for export back to the industrialized countries.

North America will also likely benefit from capital inflows from Japan and Europe. Despite high labor costs, the political and social stability of Canada and the United States are attractive, particularly to some European businesses. In addition, the erratic behavior of U.S. trade policies in the past 5 years has raised fears that selective trade barriers might be erected sometime in the future. Thus, some foreign companies, particularly the Japanese, will seek to establish facilities in the United States or Canada to guarantee access to the large U.S. market.

Canada may also be the recipient of substantial foreign investment in natural resource-based industries. The world energy situation has forcefully demonstrated to the Europeans and Japanese, as well as to everyone else, the perils of excessive dependence on unreliable suppliers

of raw materials. These countries can be expected to increase their investment levels in minerals, timber, and energy development in resource-rich developed countries like Canada and Australia (in addition to the developing countries) so as to increase their access to raw materials.

Politicization of International Economic Relations

Modest economic growth prospects, combined with persistent inflation, unemployment, and balance of payments problems, will lead to intense export competition within the industrialized countries and between the developed and developing worlds. As a result, international economic relations are likely to become increasingly politicized. Energy import and export policies, tariff rates, the level and price of agricultural exports, and foreign investment policies all may become more frequently utilized instruments of foreign policy. The recent efforts by the United States and its allies to use economic sanctions against the USSR may presage their wider use for political purposes in the future. For a subnational entity like Alberta, whose economic welfare is greatly influenced by external forces, this implies even less control over its economic destiny in the future than at present.

Economic Opportunities in East Asia

The relatively bright outlook for political stability and economic growth in East Asia will be a source of considerable opportunity for Canada, particularly the western provinces. The rapidly growing economies of the region will generate a swelling demand for raw materials of all types, including minerals, timber, and coal. Although much of this demand can be met within the region and from Australia, Malaysia,

Indonesia, and the Philippines, the resource-poor countries such as South Korea, Japan, Hong Kong, Taiwan, and Singapore will be attractive markets for Canada. Exports of Canadian agricultural products to East Asia will also have considerable expansion potential.

From the viewpoint of the East Asian countries, Canada may also be an increasingly attractive alternative to the United States for commercial dealings. The United States has an essential political and military role to play in the Pacific, but the importance of this role can act as a constraint on economic relationships. For example, South Korea's dependence on the United States for its security limits its ability to forcefully protest import restrictions on textiles and television sets. Commercial relations with Canada, by contrast, have fewer strings attached. Thus, trade and investment initiatives on the part of Canada might be well received in East Asia. In addition, Canada could be increasingly viewed as a gateway to the North American market that would avoid some of the problems of dealing directly with the United States.

# VOLUME II

## CHAPTER V

## CANADIAN ECONOMIC AND POLITICAL OUTLOOK

## V CANADIAN ECONOMIC AND POLITICAL OUTLOOK

### Overview of the Economic Outlook

As Table 2 shows, Canada experienced average annual growth rates of real GNP of 4.6% in the 1950s and 5.2% in the 1960s. The strong growth pattern of the 1960s continued through the first half of the 1970s, during which real GNP expanded at a 5.0% per year rate. During the latter half of the 1970s, however, growth slowed substantially to an average of only 2.9% per year. In line with the recession in the United States, GNP growth in Canada in 1980 is expected to be negligible. The economy should strengthen beginning in 1981, but average growth throughout the 1980-1995 period is expected to be a modest 3.5%.

Table 2

CANADIAN ECONOMIC INDICATORS
(Percent)

| | 1950-1960 | 1960-1970 | 1970-1980 | 1980-1985 | 1985-1990 | 1990-1995 |
|---|---|---|---|---|---|---|
| Average annual growth of real GNP | 4.6 | 5.2 | 3.9 | 3.4 | 3.6 | 3.5 |
| Average annual inflation rate | 2.9 | 3.2 | 8.7 | 7.4 | 7.2 | 6.6 |
| Average annual unemployment rate | n.a. | 4.4 | 6.7 | 7.4 | 6.5 | 6.0 |

Inflation will remain a major concern. In the past, inflation rates in Canada have been similar to those in the United States, but have averaged about half of a percentage point higher. This pattern is projected to continue. Canadian inflation as measured by the GNP deflator is expected to average 7.4% per year from 1980 to 1985, easing slightly to a 7.2% annual rate in 1985-1990 and 6.6% per year in 1990-1995.

Unemployment has been a persistent problem due in part to rapid growth in the labor force in Canada. During the 1950s and 1960s, the labor force expanded at an annual rate of 2.5% per year, and then grew at an even more rapid rate of 3.5% per year in 1970 to 1975. In recent years, labor force growth has slowed considerably because of the changing age structure of the population and reduced immigration. It is expected to slow further to an average rate of around 2% per year during the 1980s and 1.5% per year during the first half of the 1990s. This will help ease, but will not overcome, the unemployment problem. With the current high level of unemployment and a modest outlook for economic growth, unemployment is expected to average more than 7% in the 1980s and 6.6% in the first half of the 1990s.

For at least the next 5 years, there will be wide regional differences in Canada's economic outlook. Much of the economic growth is expected to be concentrated in the west, particularly in Alberta where energy investments are undergoing rapid expansion. Central Canada, Ontario, and particularly Quebec will be beset by higher energy prices, a decline in the competitiveness of Canadian manufacturing industries, and political uncertainties stemming from unresolved federal/provincial differences. The Atlantic provinces will be handicapped not only by

these problems but also by the declining federal capability to redistribute income to less prosperous regions.

Over time, regional differences in economic growth are expected to diminish somewhat. The current boom in western Canada may slow later in the 1980s if energy development activities level off, and energy discoveries and fisheries development off the Atlantic coast may encourage more rapid growth in the eastern provinces. The maintenance of energy prices below world market levels could be beneficial to central Canada, giving high energy-using industries there a competitive edge over U.S. companies.

The regional disparities in economic prospects will encourage further westward movement of the Canadian population. Expanding population and economic growth will strengthen the political influence of the western provinces and the provincial point of view in the debate over the division of federal and provincial powers. Nevertheless, these trends will not radically alter the relative roles of the west and central Canada in the national economy. At present, the west accounts for 27% of the nation's population, and central Canada 68%; by 1995, the west at most may approach one-third of the nation's population, but the central provinces will still account for at least 60%. The shift in economic and political influence to the west, however, could well be greater, depending on the skill with which it is exercised.

## Economic Links Between Canada and the United States

The influence of the U.S. economy on Canada arises not only from the former's size and proximity, but also from the ease of communications arising from common language and traditions and from long-established

trade and investment relationships. U.S.-Canadian ties have increased in recent decades despite some Canadian efforts to reduce dependence on the United States.

The U.S. share of total Canadian trade rose from 54% in 1960 to 68% in 1976. U.S. direct investments in Canada totaled more than C$36 billion at the end of 1978 and have been growing by about 7% per year. U.S. investors account for 73% of foreign-controlled companies in Canada and control 57% of Canadian manufacturing, 59% of mining, and an even higher proportion of some resource industries. The United States is also the major source of Canada's international borrowing, which has increased at a rapid pace in the past 7 years. Foreign liabilities totaled more than C$106 billion at the end of 1977, over half of which were loans or other portfolio investments. Canadian investments in the United States have also sharply accelerated over the past decade and totaled more than C$5 billion at the end of 1976. On a per capita basis, Canadian investment in the United States is now larger than U.S. investment in Canada.

Because of the many linkages between the two countries, major changes in the U.S. economy have tended to be reflected in the Canadian economy within 6 to 8 months. Canada thus tends to follow the same cyclical fluctuations as those of the United States. Efforts to isolate the Canadian economy from these influences, or to offset them, have not been very successful.

## Population

Canada has experienced the highest rate of population growth of any developed country in the postwar period. A baby boom lasting through the 1950s together with high immigration caused population to grow at an average rate of 3% per year in the 1950s. Sharply lower birth rates, as well as somewhat lower net immigration, caused population growth to slow significantly to a 1.8% per year rate during the 1960s and to a 1.4% per year rate during the first half of the 1970s. Population growth is expected to continue to slow somewhat from recent rates and is projected to average 1.2% per year in the 1980-1995 period.

## Energy

Energy production has always played a large role in the Canadian economy. It has become an especially important engine for Canadian growth since energy prices began escalating in 1973. Energy investment as a share of gross business investment roughly doubled during the 1970s to around 30% and is expected to increase even further during the next several years. Higher world energy prices are improving the economic attractiveness of Canada's energy resources, leading to their accelerated development. This includes not only heavy oil and tar sands and remote gas deposits, but also large coal, hydroelectric, and uranium resources. Higher prices have also enabled increased exploration and considerable expansion of known resources.

The sustained boom in energy development acts as a stimulus to investments, particularly in those industries that are suppliers of the energy industry. Canada's energy resources also benefit those industries that are major energy consumers by providing secure supplies at prices below world market levels.

Capital Investment

Gross fixed capital formation grew in constant value terms by an average of 4% to 5% per year during the two decades prior to 1975. It steadily declined during 1975 and 1976, reaching essentially zero growth in 1977 and 1978. The modest improvement during the past year may be short-lived in view of the economic slowdown in 1980, but with the special stimulus of energy investments and a gradual easing of the political and economic uncertainties that have arisen during the past 5 years, an average annual expansion of gross fixed capital formation of 3% to 4% in real terms is expected in the 1980s. There are, however, several reasons why this level of investment may not generate as much economic growth as it would have in the past.

Much of future investment will go into energy, particularly hydro- and nuclear power and oil sands development, which is highly capital-intensive and has a delayed effect on output. Capital investments to protect the environment also are becoming increasingly important. The share of capital now required for this purpose is relatively small--although as high as 10% to 15% of new investment in some industries--but it is expected to rise progressively over the next decade. Such investments will have a significant impact on costs without contributing to productivity. The changing competitive position of Canadian industry is forcing a further shift in investment away from labor-intensive light industries to capital-intensive resource processing industries.

All these forces will increase Canada's need for capital investment and channel capital into uses with less immediate impact on output. As a result, even though Canada achieved GNP growth rates averaging over 5%

per year during the 1950s and 1960s with gross fixed capital formation averaging about 22% of GNP, future GNP growth of even 4% per year would probably require a capital investment level equal to 24% to 26% of GNP. Such a strong increase in investment is likely to occur only if government policies are adopted that create an economic environment much more favorable to domestic saving and to foreign capital inflows. It seems doubtful, then, that the average ratio of capital formation to GNP will approach 24% before the last half of the 1980s, if ever.

Productivity and International Competitiveness

Over the past two decades, Canada has gradually lost an important economic advantage--lower labor costs than in the United States--that previously helped it maintain its international competitiveness, attract investment, and grow. A study by the Canadian Conference Board found that average earnings for production workers in 64 goods-producing industries were 75% of U.S. earnings in 1966, but had risen to 102% by 1975. In the same period, average Canadian earnings in 19 service industries rose from 82% to 112% in U.S. earnings. In the past several years, hourly earnings in Canada have continued to rise more rapidly than those in the United States. Because of the depreciation of the Canadian dollar since 1977, however, average Canadian earnings as measured in U.S. currency were 10% to 15% below U.S. levels by the end of 1978.

The impact of this rapid rise in Canadian labor costs was partially offset by a stronger increase in productivity in Canada than in the United States. Nevertheless, the cost of labor per unit of output has risen more rapidly in Canada, increasing by an average of 5.4% per year during 1965-1978, compared with 4% in the United States. Labor productivity

in Canada has in any case always been substantially lower than in the United States, due primarily to Canada's smaller scale production units. Canada's relative productivity in 33 industries was estimated to be only 77% of U.S. levels in 1974.

Much of Canada's higher productivity growth has come from the great expansion in efficiency in the motor vehicle industry since 1965 and from continued consolidation of the agricultural sector. However, Canada is not likely to receive a further special stimulus to productivity from these sources in the future. Because the other major contributor to Canada's higher growth in productivity--increases in capital investment--also faces future difficulties, productivity is not expected to grow much more rapidly than in the United States, especially in the near term.

Another factor that will influence Canada's competitive position in the future is the recently concluded reduction of tariffs and other trade barriers in the Tokyo Round of the General Agreement on Tariffs and Trade. This provides for a gradual reduction of tariffs by Canada and its major trading partners in seven equal installments between 1980 and 1987. Tariffs will be reduced over this period by a total of about 40%. The average level of Canadian tariffs will decline from around 15% to 9% and of U.S. tariffs from about 7% to 4%. The reduction of domestic tariffs will increase competitive pressures, but opportunities will be created through lower foreign tariffs. Both conditions will stimulate Canadian business to improve productivity. Moreover, now that these multilateral negotiations have been concluded, bilateral tariff negotiations between Canada and the United States can be pursued and eventually could have a similar and possibly stronger effect on productivity.

Of greater long-term significance to Canada's competitive position is a proposed effort to reverse the declining trend in research and development expenditures. Such expenditures as a share of GNP have been falling in Canada for some time and at present are only about 0.9%. This compared with more than 2.0% in the United States, West Germany, Japan, and The Netherlands, 1.9% in France, 1.6% in Sweden, and 1.2% in Denmark. Political leaders in both major parties have recently advocated raising the level of expenditure in Canada to 1.5% or even higher. Some measures have begun to be taken to increase the incentives for research by industrial and other private concerns and to raise government research expenditures. Although there are many impediments to rapid expansion in research and development activities and some uncertainty as to how directly or immediately such expenditures affect productivity, these efforts seem likely to continue and to contribute ultimately to productivity improvement.

Balance of Payments

Canada's substantial deficit on its current account balance reflects a cluster of trends, some recent and some long-standing, that could hamper economic growth in the future, destabilize exchange rates, and accelerate inflation. As Table 3 shows, the deficit on current account has risen from an annual average of C$1.2 billion in the period 1971 to 1975 more than C$5 billion in 1978 and C$6 billion in 1979. The deficit as a percentage of GNP has grown from about 1% in the early 1970s to more than 2.5% in 1979.

Table 3

CANADIAN BALANCE OF PAYMENTS, 1970-1979
(C$ Billions)

| | 1970 | 1971 | 1972 | 1973 | 1974 | 1975 | 1976 | 1977 | 1978 |
|---|---|---|---|---|---|---|---|---|---|
| Current account | | | | | | | | | |
| Merchandise exports | 16.9 | 17.9 | 20.1 | 25.5 | 32.6 | 33.5 | 38.1 | 44.6 | 52.4 |
| Merchandise imports | 13.9 | 15.3 | 18.3 | 22.7 | 30.9 | 34.0 | 36.8 | 41.7 | 48.9 |
| Trade balance | 3.0 | 2.6 | 1.9 | 2.7 | 1.7 | -0.5 | 1.3 | 2.9 | 3.5 |
| Services, net | -2.1 | -2.4 | -2.5 | -3.0 | -3.7 | -4.7 | -5.7 | -7.4 | -8.7 |
| Travel, net | -0.2 | -0.2 | -0.2 | -0.3 | -0.3 | -0.7 | -1.2 | -1.6 | -1.7 |
| Int. and div., net | -1.0 | -1.1 | -1.0 | -1.3 | -1.6 | -2.0 | -2.5 | -3.5 | -4.3 |
| Other, net | -0.9 | -1.1 | -1.2 | -1.4 | -1.9 | -2.0 | -2.0 | -2.3 | -2.7 |
| Transfers, net | 0.2 | 0.3 | 0.3 | 0.3 | 0.6 | 0.4 | 0.5 | 0.4 | 0 |
| Balance | 1.1 | 0.4 | -0.4 | 0.1 | -1.5 | -4.8 | -3.8 | -4.2 | -5.3 |
| Capital account | | | | | | | | | |
| Direct investment | | | | | | | | | |
| In Canada | 0.9 | 0.9 | 0.6 | 0.8 | 0.8 | 0.7 | -0.3 | 0.5 | -0.2 |
| Abroad | -0.3 | -0.2 | -0.4 | -0.8 | -0.8 | -0.9 | -0.6 | -0.7 | -1.8 |
| Total | 0.6 | 0.7 | 0.2 | 0 | 0 | -0.2 | -0.9 | -0.2 | -2.0 |
| Portfolio transactions, net | 0.6 | 0.3 | 1.6 | 0.7 | 1.8 | 4.5 | 8.6 | 5.4 | 5.1 |

Note: Aggregates may not add due to rounding.

There are several factors that account for the swelling deficit. Canada's traditional surplus in merchandise trade grew slowly in the second half of the 1970s despite a nearly 20% devaluation of the Canadian dollar in relation to the U.S. dollar between 1976 to 1978. The trade surplus has been hurt by a shift of the net balance of trade in both oil and motor vehicles from small surpluses in the early 1970s to deficits for both categories exceeding C$1 billion per year since 1976.

The trade surplus has been more than offset by an explosion in the deficit for services over the past 7 years. About one-half of the services deficit--and much of its recent growth--is due to interest and dividend payments. Canada's shift to much greater reliance on foreign borrowing rather than on foreign equity investments contributed substantially to the rise in foreign payments of interest and dividends. The sharp rise in interest rates in the past 2 years has exacerbated the problem, as has increased borrowing to finance the overall payments deficit and to support current exchange rate levels.

Another major factor in the worsening of the service deficit is the deficit in the travel account. An increasing share of the Canadian population is able to afford vacations abroad, particularly during Canada's cold winters. Despite Canada's increasing attractiveness to U.S., European, and Japanese tourists, the inflow of tourism revenues has been growing much less rapidly than the outflow.

Policies to reduce inflation, encourage domestic savings, induce the replacement of foreign debt with equity capital, and stimulate tourism in Canada and discourage travel abroad could all help reduce the growth in the service deficit. Improvements in some of these areas

will be made, but there is little prospect for a major reversal in the service account trend.

Much, then, depends on accelerating the growth in the surplus in the merchandise trade account. The most promising elements are rising energy prices and an apparent willingness of the government to authorize gas, electricity, and other energy exports. Higher prices alone should increase gas export revenues in 1980 by nearly C$1 billion to more than C$4 billion. Some increase in the volume of gas exports was authorized in 1979 in the light of large gas finds, and further liberalization is possible.

An increase in the Canadian share of foreign markets for resource-based exports is another way that Canada's merchandise surplus might be increased. The decline in the value of the Canadian dollar has helped modestly in recent years. Over the long run, the terms of trade of many of Canada's resources may gradually improve, but this is unlikely to provide any major or immediate contribution to lessening Canada's current account deficit.

Another way to reduce the deficit is to improve the international competitiveness of Canadian manufacturers, but political constraints will make it difficult for Ottawa to substantially reduce wage gains or control inflation. There is some prospect that business will rationalize product lines and production methods and that new investments will contribute to rising productivity. Indeed business investment has begun to revive in response to increasing tax incentives and the conclusion of the GATT agreement which promises to reduce trade barriers. Diminishing idle capacity and the conviction that the political environment is

neither likely to deteriorate nor to improve greatly in the near future may have also spurred increased business agressiveness. The revival of business initiative is likely to continue once the current economic slowdown is over and as business adjusts to the continuing existence of political and economic uncertainties.

Concern over the trend in Canada's balance of payments could be temporarily alleviated by large international capital inflows to finance attractive energy projects, such as proposed multibillion dollar pipelines, tar sands plants, and hydroelectric power stations. These, however, will offer only temporary relief to the fundamental balance of payments problem, and should such capital inflows push up the value of the Canadian dollar, they could make the ultimate restoration of balance in Canada's accounts even more difficult.

The net effect of all these factors--particularly the likelihood of expanded energy exports--will probably be a stabilization or reduction of the deficit without requiring more than small exchange rate adjustments. Should the deficit continue to rise at a rate requiring major exchange rate changes, however, Canada might have to seek special cooperation from international lenders in financing stabilization efforts. Requirements for such cooperation could include stringent fiscal and monetary policies.

## The Political Framework for Business Activity

The high rates of economic growth that Canada experienced in the 1950s, 1960s, and first half of the 1970s can be attributed in good part to its ability to attract foreign capital and foreign technology. This in turn was due as much to Canada's providing an attractive political

environment in which to do business as to the availability of profitable investment opportunities. For many American and Commonwealth investors, Canada's tradition of stable government, its familiar and impartial legal system, the prevalence of the English language, and a favorable regulatory climate placed it at the top of their lists as a foreign investment site.

In some respects, this is not quite as important as it once was. Many international investors are now well experienced in coping with foreign languages and legal systems and assuming the risks of less stable political environments. In another respect, however, it has become an increasingly important determinant of Canada's ability to attract or to hold investment. Many Canadian companies are now sufficiently large that they can consider the United States as an alternative investment location if the Canadian political environment becomes less attractive for business. A favorable Canadian political environment is thus doubly important both to attract foreign investors and to prevent domestic companies from investing their funds elsewhere.

Three main types of threatened change in the political framework for business are relevant in considering Canada's economic outlook. These are:

- A drastic change in the political-economic environment under which business now operates; e.g., an actually or virtually independent Quebec resulting in fragmentation of the Canadian market.
- A substantial change in the political-economic environment making business much more complex and less profitable; e.g., the existence of a federal government generally hostile to business or foreign investment and favoring socialist or statist policies.

- A deterioration in political leadership leading to a prolonged period of unsound fiscal, monetary, and other economic policies.

The threat of a drastic alteration in the political-economic environment resulting from a change in Quebec's relations with the rest of Canada has, in recent years, caused many investors to postpone investments in Canada and others to relocate investments outside of Quebec or Canada. The outcome of the 1980 referendum indicates that economically disruptive separation is not likely to occur, even though deep rooted support will remain in Quebec for advancing Francophone interests. Nonetheless, although most potential investors are not expected to be deterred by the Quebec issue alone, it will remain a substantial negative consideration that, in combination with other factors, will be decisive for some in the years ahead.

The threat of a substantial change in the political-economic environment making business much more difficult and less profitable became a serious deterrent to investment in the mid-1970s at about the same time as fears about Quebec separation were rising. Economic uncertainties (along with increased government levies on resource industries), expansion of direct government participation in business activities, the imposition of screening and new obligations on foreign investors, expansion of environmental regulations, and wage and price controls aroused strong fears in the business community. In the past few years these fears have generally been allayed, first by an easing of objectionable policies at the end of the last Trudeau administration and then by their general reversal under the brief Clark administration. Although political trends have

no assured stability for long periods, the need to encourage investment is likely to be a dominant government concern shaping policy over the next decade.

The threat of weak leadership stems not so much from the qualities of key leaders and the confidence they can command from the public at large, but in the emergence of deep political divisions in the Canadian body politic. Important problems for which no consensus exists for their resolution are:

- The determination of the Francophone community to secure all of the economic advantages of the dominant culture in the face of Anglophone resistance.
- The inability of the Canadian electorate, because of differences on how the costs should be shared, to agree on a program that would steadily reduce inflation.
- The existence of established policies that, on one hand, accord provinces jurisdiction over resources and, on the other, require the federal government to equalize services and opportunities to citizens of all provinces.
- A division of political power between provinces representing regional interests and between parties of different political philosophies that may enable minorities both in the provinces and in Ottawa to block majority initiatives and to discourage compromises needed for effective action.

In summary, the political environment for business activity will not be as conducive to investment and economic growth as it was in the 1950s or 1960s. Additional risks and costs will cause investors to be more cautious and may also discourage savings. Thus, it is expected that the political-economic system will function less well than it could and will hold economic growth substantially below its potential.

## Implications of the Canadian Outlook for Alberta

Almost every aspect of the broad Canadian political and economic environment will have an impact on Alberta. In some ways Alberta may

gain from the problems that beset the rest of Canada. The Albertan economy is self-contained to a significant extent. Led by a very strong energy sector, Alberta is not likely to face the general economic weakness that most of the rest of Canada will experience, at least not until the 1990s. The comparatively favorable outlook for Alberta will attract investment and talented labor from other provinces. And Canada's balance of payments problems may lead to more liberal energy export policies to the benefit of Alberta.

The most significant benefit that Alberta is likely to realize is the substantial strengthening of its economic and political influence within the Canadian federation. A gradual shift of power from the central provinces to the western provinces has been under way for some time. But the strategic and economic importance of the west's energy resources has really blossomed only during the past decade as world oil prices have soared, and the political leverage flowing from that energy base is only beginning to emerge. As a result, Alberta will be well placed in the future to gain a more careful federal consideration of its policy positions on issues such as pricing and export levels for energy and agricultural products. Within the next several years, changes in federal-provincial relations are likely that will enhance provincial authority and participation in activities largely under federal control. Federal policies and regulations may be modified in ways that will partially accommodate the long-standing economic concerns of the western and Atlantic provinces and Quebec.

# VOLUME II
## CHAPTER VI

## ALTERNATIVE SCENARIOS

## VI ALTERNATIVE SCENARIOS

The preceding sections of this volume have discussed the most probable course of political and economic developments in Canada and the rest of the world during the next 15 years. As emphasized several times, however, the world faces many uncertainties in the years ahead that could drastically alter the global outlook. To analyze the sensitivity of the Alberta economy to some of the uncertainties in the external environment, four alternative scenarios of world conditions were developed. These scenarios were based on alternative assumptions concerning three major uncertainties: the general health of the world economy, the future level of world oil prices, and the value of the Canadian dollar relative to the U.S. dollar. Table 4 shows some of the more important economic parameters that define the "base case" and the four alternative scenarios. The impacts of these alternative assumptions will be discussed in Volume III of this report in connection with the analysis of the Albertan economy.

### Base Case

Given the political and economic forces that are expected to shape the world economy in the future, real economic growth for the world as a whole is projected to average about 3.8% per year in the 1980-1985 period. Growth in both Canada and the United States will be below the world average although the Canadian economy is expected to be somewhat stronger than the economies of the industrialized countries as a whole. Because of political instability in the Middle East and continued dependence of

Table 4

MAJOR ECONOMIC PARAMETERS OF ALTERNATIVE SCENARIOS

| | Base Case | Alternative Scenarios | | | |
|---|---|---|---|---|---|
| | | 1 | 2 | 3 | 4 |
| Average annual real GNP growth: 1980-1995 | | | | | |
| World | 3.8 | 3.3 | 3.1 | 4.1 | 3.8 |
| Canada | 3.5 | 3.0 | 2.9 | 3.6 | 3.2 |
| United States | 3.0 | 2.6 | 2.4 | 3.2 | 3.0 |
| World oil price* | | | | | |
| 1985 | 41.10 | 41.10 | 60.70 | 37.50 | 41.10 |
| 1990 | 60.50 | 60.50 | 87.50 | 50.10 | 60.50 |
| 1995 | 88.80 | 88.80 | 111.70 | 67.10 | 88.80 |
| Canadian dollar† | | | | | |
| 1985 | 0.86 | 0.86 | 0.94 | 0.86 | 0.80 |
| 1990 | 0.86 | 0.86 | 0.92 | 0.86 | 0.75 |
| 1995 | 0.86 | 0.86 | 0.92 | 0.86 | 0.75 |

*Weighted average nominal price per barrel in U.S. dollars for OPEC crude oil at point of shipment.

†U.S. dollars per Canadian dollar.

the West on imported oil throughout the next 15 years and beyond, it is assumed that world oil prices will increase at an average rate of 8% per year (2% per year in real terms). This will mean an average OPEC price of almost $90 per barrel in current U.S. dollars in 1995. The Canadian dollar is expected to strengthen marginally relative to the U.S. dollar over the next few years, but then return to its recent rate of US$0.86 by the mid-1980s. This rate is then assumed to hold on average through the following 10 years.

Alternative 1: Weak World Economy

In discussions of the base case world economic outlook in Section III, a number of fundamental problems afflicting the developed and developing countries were identified. For the most part, it was concluded that these forces would have a moderately negative, but not devastating, impact on world economic growth. However, some or all of these problems could prove to be considerably more intractable and disruptive than is at present considered probable. The first alternative scenario, then, is predicated on the assumption of a significantly weaker world economic environment resulting from adverse development in factors other than the world oil situation (which will be treated in the next two scenarios). Average real GNP growth for the world is assumed to be 3.3% per year in 1980-1995, one-half of a percentage point less than in the base case. Real GNP growth rates are assumed to be 3.0% per year in Canada and 2.6% per year in the United States.

Alternative 2: Higher Oil Prices

The rate of increase of oil prices in the base case (2% per year in real terms) incorporated the expectation of periodic, although not drastic, disruptions in the supply of Middle Eastern oil during the next 15 years. The possibility of more substantial interruptions in supply, however, is considerable. Or, the OPEC countries might succeed in jointly restricting their production rates so as to push prices up more rapidly. This alternative scenario assumes that either major supply disruptions occur or output is voluntarily restrained, leading to an average annual real increase in OPEC oil prices of about 3.5%. The dangers of rapid price escalation appear greatest in the near term, so the real rate of price increase is assumed to be greatest--about 8% per year--in the 1980-1985 interval, tapering off to a 1.5% per year rate in 1985-1990 and to zero real increase after 1990. This price path leads to a nominal price of over US$111 per barrel in 1995, 26% higher than in the base case.

This scenario also assumes the presence of the general weakness throughout the world economy that was incorporated in Alternative 1 above. In this case, the higher oil prices produce even slower world economic growth--3.1% per year in real terms for the 1980-1995 period compared with 3.3% per year in Alternative 1 and 3.8% per year in the base case.

Alternative 3: Lower Oil Prices

Despite the likelihood that oil prices will continue to increase in real terms, it is conceivable that OPEC might act to restrict the rate of oil price escalation. The OPEC countries, for example, might

view their continued security from the threat of Russian penetration in the Middle East as requiring an economically strong and friendly West as a counterbalance to the USSR. Thus, the Middle Eastern OPEC countries could pursue a long-term pricing policy designed to avoid a continually increasing financial drain on the oil importing countries. It is assumed in this scenario that oil prices remain steady in real terms throughout the 1980-1995 period. This would lead to a stronger world economy, with average real economic growth of 4.1% per year as compared with 3.8% per year in the base case.

Alternative 4: Weak Canadian Dollar

As discussed at length in Section V, the Canadian balance of payments has deteriorated substantially in recent years. Although there are reasons to expect some improvement in the future, serious fundamental problems remain. The impact of the balance of payments deficits on the value of the Canadian dollar in exchange markets is partly financial and partly psychological. If it appears that efforts are being made to rectify the payments imbalance--for example, through aggressive export policies, programs to slow the rate of inflation in Canada, and attempts to improve the efficiency of Canadian business--a slowly declining, but still large, deficit during the next 5 years or so need not put further pressure on the Canadian dollar. However, if little effort is made to deal with the payments problem and the deficit widens further, market sentiment could turn against the Canadian dollar and lead to another major decline comparable to that which occurred in 1977 and 1978. This alternative scenario assumes that the Canadian dollar falls from a rate of US$0.86 at the beginning of 1980 to US$0.80

in 1985 and US$0.75 in 1990 and 1995. This will have no impact on the world economy (compared with that in the base case), but will lower Canadian economic growth from an average real rate of 3.5% per year in the base case to 3.2% per year in this alternative.

ALBERTA

LEGISLATURE LIBRARY
216 LEGISLATURE BUILDING
EDMONTON, ALBERTA

DATE DUE
DATE DE RETOUR

LOWE-MARTIN No. 1137